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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1956.

No. 257

GORDON P. HAYNES AND ESSIE M. HAYNES,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

REPLY BRIEF ON BEHALF OF PETITIONERS.

ARGUMENT.

I.

Labeling of Payments Here Involved as "Wage Continuation" or "Sick Leave" Payments Is Inappropriate and Confuses the Issue Presented.

In its brief the Government repeatedly refers to the payments involved in this case as constituting a continuation of the taxpayer's regular salary or as "sick leave" payments. Similarly the employer's disability benefit plan, pursuant to which such payments were made, is referred to as a "wage continuation" or "sick leave" plan. Having thus categorized the plan and payments involved, the Government devotes a substantial portion of its argument to the general contention that sick leave

and wage continuation plans do not constitute "health insurance" within the meaning of the applicable statute, and that amounts paid to employees thereunder are compensation for services rather than compensation for sickness.

Such an approach unduly broadens and confuses the issue actually presented. The terms "wage continuation plan" and "sick leave plan" have no statutory significance. The Government is thus free to use them in as broad a sense as it may see fit and to include within their scope any arrangement under which payments are made to an employee during a period of illness, irrespective of its nature. But the terms as so used are of no assistance in resolving the issue in the present case. The taxpayer's position does not rest on any broad contention that all such payments are within the statutory exclusion from income.

An employer might follow the personnel practice of making payments to employees during illness, exercising its discretion in individual cases as to whether such payments shall be made and the amount thereof. Clearly this type of arrangement would not constitute "health insurance", the necessary contractual element being lacking. An employee plan might provide for an annual period of "sick leave", with continuation of wages, which may be taken irrespective of whether an employee is actually ill, so that the sick leave is really an additional period of annual leave or vacation with pay. In such a situation the payments would presumably constitute taxable compensation for services. Various statutory provisions for disability and sickness payments to governmental employees present special problems in connection with the application of the exemption, in view of their statutory rather than contrac-

tual basis, and the discretion which is usually involved as to the making of payments thereunder.*

The variety of arrangements and circumstances under which payments may be made to employees on account of sickness is very great. Obviously all such payments do not constitute amounts received as compensation for illness under health insurance within the meaning of the statute. It is equally obvious that a decision to the effect that the payments here involved are within the exemption does not require any such broad and sweeping ruling. In this case it is stipulated that the payments were made to taxpayer, as a result of his illness, under his employer's "Plan for Pensions, Disability and Death Benefits" (R. 8). The terms of the plan and the manner of its administration with respect to the payment of sickness benefits appear from the record. The question here presented is whether *this* disability benefit plan, under which the employer obligates itself to compensate its employees for loss resulting from inability to work on account of sickness on the basis of a detailed indemnity schedule, constitutes "health insurance" within the meaning of the statute. The taxpayer is not seeking tax exemption for a mere wage continuation during sick leave; to so describe the payments here involved is to assume the result for which the Government contends.

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* Under the "sick leave plan" of the Federal Government, referred to on page 19 of the Government's brief, "sick leave" is granted as an extension of "annual leave" which a department head may allow up to a maximum of thirty days per year. Such an extension of the annual leave may be allowed under specified circumstances where the illness involved is not that of the employee but of a member of his immediate family. Where the "sick leave" is on account of the employee's own illness, it is based on a determination, necessarily involving considerable discretion, that an "exceptional and meritorious" case exists, and that denial of the leave "would work a peculiar hardship".

II.

Payments to Taxpayer Constituted Compensation for Illness, Not Taxable Compensation for Services.

Any sickness benefit plan under which an employer obligates itself to indemnify its employees against loss of earnings resulting from illness may be classified in the category of fringe benefits. Under any such plan, a valuable right is received by the employees, over and above their regular compensation, in consideration of the services rendered by them. It does not follow from this, however, that the payments made to an employee who becomes ill are taxable compensation for services rendered. It is the insurance protection which is received by him in consideration for his services. The benefit payments result from the occurrence of the loss against which he is indemnified.

This case does not involve the question whether the value of the insurance protection received by all employees under a privately insured plan such as this constitutes taxable compensation. Under the law as it existed when this case arose, the value of such insurance protection afforded under individual commercial insurance policies was taxed to the covered employee, such value being measured by the premium paid therefor by the employer. On the other hand, the value of insurance protection provided through commercial group insurance policies was administratively exempt from taxation, apparently because of the difficulty involved in determining such value. (See letter of Deputy Commissioner T. Mooney, August 26, 1943, P-H 1943 Fed. Tax Serv. ¶66,294.) A similar problem would exist in the case of a self-insured plan.

But if any taxable income is to be found in the present situation, it is the *value of the protection,* which is received by all employees. Those employees, such as the taxpayer, who collect sickness benefits are not being compensated for further services but are simply realizing upon their insurance rights. It is their sickness, not their services, which brings the benefits to them and not to the others.

The Government concedes that sickness benefits paid under commercially insured employee disability plans are exempt from taxation under the statute here involved (Govt. Br. 26, n. 14). Yet such payments are no more, and no less, in the nature of compensation for services rendered than are those under a similar privately insured disability benefit plan.

III.

A Congressional Intent to Limit "Health Insurance" to Commercially Insured Sickness Benefit Plans Cannot Be Established and Should Not Be Assumed.

The Government contends that the term "health insurance" as used in the statute was intended to refer only to conventional insurance. By "conventional" insurance it appears to mean *commercial* insurance or at least insurance which conforms very closely to the practices followed by commercial insurance companies.

Clearly, as pointed out in taxpayer's original brief, the word "insurance" as commonly understood has no such restricted meaning. While the Government asserts that the contrary is true, it cites no authority whatever in support of such assertion, and its specific argument for such narrow construction is based solely on inferences which it attempts to draw from the meager statutory history.

In this connection, reference is made to language used in the report of the House Ways and Means Committee, in discussing the provisions of the Revenue Act of 1918 from which the pertinent statute is derived, to the effect that under the existing law it was doubtful whether amounts received under accident or health insurance, or under workmen's compensation acts, as compensation for personal injuries or sickness, and damages received on account of such injuries or sickness, were required to be included in gross income. The Government also refers to prior rulings by the Treasury Department and the Attorney General to the effect that proceeds of accident insurance policies do not constitute taxable income, but these rulings are not mentioned in the aforesaid Committee report (Br. 15, 16). The comment of the House Ways and Means Committee, considered in light of these prior rulings, is said to imply that the statutory provision in question was designed to exempt only proceeds received under conventional modes of insurance (i.e., commercial insurance policies).

How such an inference arises is not apparent. The circumstance that such prior rulings happened to deal specifically with accident insurance policies no more indicates a Congressional intent to exclude payments under employer self-insured health insurance plans than it indicates an intent to exclude any of the various other types of payments covered by the statute which were not dealt with in such rulings. That the then current attitude of the Treasury Department did not make the distinction for which the Government now contends is apparent from its letter ruling of December 24, 1918, to American Telephone and Telegraph Company, a copy of which is incorporated in this brief as an appendix, and in which it was ruled that amounts received by an employee from a benefit fund,

representing payments on account of death, sickness or injury, were not income.* Congress mentioned none of these rulings, but if it acted in light of any, it is just as likely that it considered the problem in the A. T. & T. ruling in connection with the legislation as the problem in the rulings cited by the Government.

It is likewise argued that the addition to the statute involved, by the Revenue Act of 1942, of express language exempting "amounts received as a pension, annuity or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country" indicates that the original language did not include all types of employer "sick leave" plans (Br. 18). Of course, as is hereinabove pointed out, petitioners make no contention that all types of plans are exempt. The amendment in question was enacted in time of war, after the draft had been put into effect, and in circumstances where a highly specialized situation existed with which Congress thought it well to deal expressly. It was rather obviously designed to extend the exclusion of the statute to pensions and annuities as well as benefits during temporary illness or disability, payable under a wide variety of possible governmental arrangements which might not qualify as "health insurance" under the existing statute.

The Government also contends that the amendment made by the Revenue Act of 1951 to Sec. 22(b) (1) of the

* This ruling is described in the testimony of the president of a subsidiary of A. T. & T. in Hearings before the Committee on Ways and Means, House of Representatives, 83d Cong., 1st Sess., on Forty Topics Pertaining to the General Revision of the Internal Revenue Code, p. 365. He stated: "In 1918 the Bureau issued a ruling that the benefits were not subject to tax. In other words, the payments under our plans were given the same treatment as payments made under commercial insurance policies." The testimony continues with a succinct history of the Internal Revenue Service's vacillation on this issue, and the considerations of equity in favor of an equal application of the law whether a plan is privately or commercially insured.

Revenue Code of 1939 indicates that the term "insurance", as used in the statute here involved does not include self-insured benefit plans (Br. 20). Such amendment added to the then existing provisions of Sec. 22(b)(1), exempting from income taxation "payments under a life insurance contract, paid by reason of the death of the insured", a further provision exempting payments under a contract of an employer within specified limitations.

Sec. 22(b)(1) originated as Sec. II(B) in the Tariff Act of 1913, 38 Stat. 114 (1913). A similar provision was contained in the Revenue Act of 1918, as Sec. 213(b)(1), 40 Stat. 1057 (1919). In both instances the statutory language referred to the "proceeds of life insurance policies". The statute here involved originated in the Revenue Act of 1918, and in it was used the obviously broader term "health insurance". In the Revenue Act of 1926, 44 Stat. 9 (1926), the term "life insurance policies" as used in the statute relating to death benefits (Sec. 213(b)(1) of that Act) was changed to "life insurance contract", the report of the Senate Committee stating that the change was made to conform the phraseology to that used in Sec. 213(b)(2) of the same Act, relating to an exclusion for the return premiums paid on a "life insurance, endowment, or annuity contract", there being no intended distinction between life insurance policies as used in the one and life insurance contract as used in the other (Senate Report No. 52, 69th Cong., 1st Sess., 1939-1 Cum. Bull. (Part 2) 347). No change was made in the term "health insurance" as contained in the subparagraph which was the predecessor statute to the one here involved. Thus, if any inference is to be drawn from the comparison of the histories of Sections 22(b)(1) and 22(b)(5) of the Revenue Code of 1939, the inference would be that Congress deliberately used a

broader term when it used the term "health insurance" and did not intend to confine its scope to conventional or commercial insurance contracts or policies. On the other hand, the history and language of Section 22(b)(1), described above, was such that an amendment was considered necessary in order to cover employee death benefits. The absence of any amendment to Section 22(b)(5) at this time really supports the broader interpretation of that section.

Finally, an effort is made to draw from the comprehensive provisions of the Internal Revenue Code of 1954 an indication of a Congressional construction of the prior law as not exempting payments under a self-insured employer sickness benefit plan. It is extremely doubtful that any inference as to the meaning of the statute here involved, originally enacted more than thirty-five years earlier, can properly be drawn from this recent enactment. Assuming that any such inference is to be drawn, however, it again appears to be contrary to the Government's contention.

The present statutory provisions make no distinction between benefits paid under an employee plan through commercial insurance and under such a plan which is self-insured, thus clearly recognizing that no different treatment taxwise is justified. The scope of the exemption is broadened, in that payments under all accident and health plans for employees are treated as amounts received under accident or health insurance irrespective of whether the plan involved meets the contractual or other requirements of the term "health insurance". Its scope is narrowed in that payments on account of personal injury or sickness which are in lieu of wages, whether made under a self-insured or commercially insured employee plan, are exempt only within specified limitations. Congress in enacting this legislation clearly recognized that all types of employee plans would not qualify as "health insurance" under the

previous statute, which was unquestionably true. It further recognized that confusion existed as to the precise scope of that term, which was also unquestionably true. The Treasury Department itself, in the long period during which the statute had existed, had never issued a regulation in this connection, and had taken varying and sometimes inconsistent positions in its rulings. It is entirely clear that the real effort of Congress was to provide *for the future* a uniform rule of taxation which could be applied equally to all situations; and it was hardly necessary or pertinent for Congress to attempt a resolution, *for the past*, of the questions under prior law. Congress saw fit to differentiate in the treatment taxwise of payments for permanent bodily impairment and payments made during sickness or disability in lieu of wages, but in doing so it provided for no different treatment between payments made directly by an employer under a self-insured plan and payments made through commercial insurance. Except insofar as the new provisions confirm the obvious fact that no reason exists for a differentiation in tax treatment between a self-insured and a commercially insured employee benefit plan, they would appear to throw no light on the construction of the former statute.

We believe that the foregoing puts the significance of the 1954 revision in its proper light, and that the several arguments appearing on pages 22 to 28 of the Government's brief will, when considered in such light, clearly appear without substance: (1) We, as well as the Government (and as did Congress), recognize a lack of uniformity under prior law. (2) The $100 a week limitation has no special significance in respect of prior law, since Congress obviously reached the conclusion that all disability arrangements in lieu of wages should be so limited, whereas under prior law there was no such limit whether or not the plan

was commercially insured. (3) The treatment under the 1954 Code of insurance proceeds where an employee purchases his own policy for cash has no relevance, either, to the meaning of prior law as applied to a self-insured disability benefits plan since the consideration for the coverage is *services*, not cash. As developed later herein, the petitioners do not seek to equate the services with a cash payment.

It is significant that the Government in its brief refers to the administrative interpretation of the pertinent statute only very briefly (Br. 36, n. 22). The reason is obvious. In no administrative ruling has the position been taken that the term "health insurance" includes only commercial insurance policies. The ruling in I. T. 4015, 1950-1 Cum. Bull. 23, which is quoted at page 23 of the brief of *amicus curiae*, expressly recognizes that a plan of the type here involved constitutes "health insurance".* More recent rulings dealing with the question whether self-insured plans are "health insurance" lay down criteria which are clearly foreign to the question of whether the arrangement is in fact insurance, and are based on policy considerations. See, in this connection, Comment, 64 Yale L. J. 222, 227. These rulings continue to recognize, however, that the exemption relates to self-insured as well as commercially insured plans.

It is also highly significant that the Government in its brief suggests no possible reason why Congress might have intended to afford the exemption to payments on account of sickness under a commercially insured employee plan but not under a similar self-insured plan. If the specific benefits here involved had been paid, under this specific plan, through a group insurance policy rather

* That the Commissioner could and did so characterize the plan in I. T. 4015 contradicts the Government's present contention that the common understanding of the term "insurance" would not encompass such a plan.

than directly by the employer, the Government would concede that they would be exempt from taxation. It is difficult to assume that Congress intended to differentiate between the two situations solely in order to encourage the purchase of commercial insurance policies, or to discriminate taxwise between employees receiving identical sickness benefits.

IV.

The Government Has Not Faced the Question Directly, but Has Pointed to a Series of Irrelevant or Inconsequential Considerations to Support Its Position That Insurance Is Not Present.

We have seen that the Court must pass upon the character of the particular Plan in issue, not upon disability benefits, sick leave, and wage continuations generally. We have also seen that although a disability benefit plan is a "fringe benefit" in the employment arrangement, benefits paid are not compensation as such—and certainly not compensation of a kind that Congress would have wanted to exclude from the relief granted in Section 22(b)(5). It is also clear that the exemption is not confined to policies issued by commercial insurance companies; and that the so-called legislative history relied upon by the Government is entirely too "thin" to support either the contrary view or the specific proposition that a plan of the kind here involved does not meet the purpose of Congress in exempting amounts received through "health insurance".

Both the Government and the Court, therefore, must ultimately face the question directly. It is perfectly obvious that Congress——

(1) Avoided restrictive terminology, such as "policies", "proceeds", "insurance contracts", "insurance companies", "conventional insurance", "commercial insurance", and "insurance carrier", and chose to use a simple, broad and generic term—"insurance"—well known in the law and embracing substantially all contractual arrangements for the assumption by one party of a risk of loss by another; and

(2) At the same time sought to relieve from tax amounts received by the taxpayer only because of the misfortune of illness or accident.

The present Plan meets both of these conditions fully, and this fact cannot be obscured by either elaborate speculation as to the precise nuances of various Congressional actions over a period of 36 years, or by listing a series of alleged and inconsequential differences from commercial insurance. Yet the Government's brief does little more. Note the emphasis placed on the following points, *none of which goes to the heart of the matter:*

1. It is stated that the Plan does not fall within the ambit of state regulation of insurance companies (Br. 30). This is totally irrelevant, for the company here is not insuring the general public but only its own employees.

2. It is argued that the benefits provided are governed by the length of service, so that persons with identical risks are not identically insured (Br. 31-32). This overlooks the obvious fact that persons rendering longer service supply a greater consideration. Furthermore, the benefits are certainly keyed primarily to periods of *sickness*, not service. There is no fixed period of "sick leave", and no right to accumulate time for sickness absence; and the gradations in coverage are in broad classes unrelated to the salary

of the employee or the importance of his services or position.

3. It is argued that payments during the first seven days of sickness are taxable, and indistinguishable (Br. 32-33). We do not know whether such payments are taxable or tax-exempt. This has never been decided, and the Court does not have such question before it. We do know that such payments are separately identified and accounted for by the Company in its accounting and other records (R. 27); that they are not made under a disability benefits plan such as is here involved; that there is no written contract establishing a schedule of indemnity on which they are based; and that they appear to be nothing more than permission to certain employees to be absent for a limited time without loss of pay.

4. It is argued that the petitioners are relying upon a "theoretical wage differential" to find a payment of "premiums"; that this is an "esoteric concept derived from subtle and theoretic analysis"; and that Congress has not recognized, in computing income and medical expense deductions, the presence of any such constructive cash premium (Br. 33-35).

This is all far fetched and illustrates how hard-pressed the Government is for argument. The petitioners rely simply on the rendering of *valuable services* as the consideration for the insurance protection —not upon a payment of cash—and there is nothing "esoteric", "subtle" or even "theoretic" about this. Billions of dollars are exchanged for services every year; and their economic worth is as clear, plain and practical as that of property.

5. The alleged necessity of a separate "fund" is also stressed (Br. 36-37). This is one of the least substantial considerations, for insurance originated as an unfunded arrangement (see *Amicus* Br. 27) and the fact is that a separate fund is *not* characteristic of

typical commercial insurance. That is, if the company had procured a group policy covering its Plan, the premium payment would have gone into the general assets of the insurance company and would not have been held as a separate fund for satisfaction of claims under the policy. The general assets of the company here were fully as available, and as much a "separate fund", for such purpose as would have been the general assets of the insurance company.*

6. It is asserted that, unlike commercial insurance, there is no actuarial determination of risks and costs (Br. 37). The trial court so stated (R. 51), but the record is merely to the effect that no contributions to a fund were made (R. 18). The record is actually silent on whether or how costs were determined; but common sense tells us that a cost item of $1,700,000 a year must be considered by the company as substantial, and that actuarial techniques would be used to forecast this expense. In any event, this is at best remote from the issue.

7. It is argued that costs, expenses and benefits of the Plan were treated as any other business expenses. This is, indeed, a vague argument virtually unrelated to the central issue. The record clearly shows that such items were the subject of separate accounting treatment throughout and were always identified as such (R. 25, 27, 29, 30-31).

8. It is certainly not important that the company withheld income tax on the benefits at issue in this particular case (Br. 37) as this was a natural protective step on its own part.

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* It may be noted, in passing, that on p. 36 of its Brief, the Government seems to admit that "commercial" insurance is not essential to the exemption, and in Note 22 cites Service rulings applying the exemption to plans not commercially insured. This suggests that the emphasis on minor features of commercial insurance is misplaced, as we argue above.

9. It is equally unimportant that a single check might include benefits and wages (Br. 37), since the record clearly shows that the amounts included in the check were separately stated in writing to the employee (R. 25, 30-31).

10. Absence of coverage during lay-off periods (Br. 37) is characteristic of commercially insured disability benefit plans.

11. Ineligibility while receiving wages (Br. 37) emphasizes the nature of the benefits as compensation for sickness rather than for services.

12. Payment of discretionary benefits greater than those required under the Plan (Br. 38) makes it all the more clear that those required are contractual in nature.

13. The fact that the Plan is subject to modification prospectively (Br. 38) surely cannot be significant, for insurance policies are commonly subject to cancellation as to losses not yet incurred.

Thus the Government collects a dozen or so supposed indicia of insurance, most of them irrelevant and certainly none of major significance, to argue that "in its totality" the Plan cannot be classified as providing compensation for sickness under health insurance (Br. 30). Yet it fails to inquire directly into the substance of the matter, or to search legal precedent for the meaning of the common legal term used by Congress in the statute. This evasion of the issue is explicable only in terms of inability to face it successfully.

Conclusion

On the basis of the foregoing it is submitted that the Government has totally failed to meet the petitioners' position that the Plan here involved is "health insurance" within the meaning of the statute.

Respectfully submitted,

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Certificate of Service.

This is to certify that I have served a copy of the Reply Brief on behalf of petitioners on the following persons, by depositing in the United States mail a copy of said Reply Brief in a properly addressed envelope with adequate postage thereon, as indicated below:

1. Hon. James W. Dorsey, United States Attorney, Old Post Office Building, Atlanta 3, Georgia, by air mail;

2. The Solicitor General, Department of Justice, Washington 25, D. C., by air mail;

3. Hon. Harlan Pomeroy, Trial Attorney, Department of Justice, Washington 25, D. C., by air mail.

This 7 day of March, 1957.

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Of Counsel for Petitioners

APPENDIX.

TREASURY DEPARTMENT

WASHINGTON

Office of
Commissioner of Internal Revenue
Address Reply to
Commissioner of Internal Revenue
and Refer to
IT:PA
HCA

Dec. 24, 1918

American Telephone and Telegraph Company,
195 Broadway,
New York, N. Y.

Sirs:

Reference is made to your letter dated December 11, 1918, with reference to T. D. 2747 in which it was held that the proceeds of an accident insurance policy received by an individual on account of personal injuries sustained by him through accident and amounts received by an individual as a result of a suit or compromise for injuries sustained by him through accident do not represent income subject to tax under the Act of September 8, 1916, as amended.

In reply to your inquiry as to the theory upon which the ruling is based and to the taxable status of amounts received by employees under benefit fund plans, you are advised that the ruling was based on Doyle vs. Mitchell Bros., decided by the Supreme Court under date of May 20, 1918, and other cases wherein reference was made to the case of Stratton's Independence vs. Howbert, 231 U. S., 399, 415, in which it was stated that "income may be defined as the gain derived from capital, from labor, or from both combined."

It is therefore held that amounts received by an employee or his personal representative from a benefit fund, which represents payment on account of death, sickness or injury of an employee is not income within the meaning of the Act.

Respectfully,

P. S. TALBERT
Acting Deputy Commissioner.